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ECONOMY

The outlook for inflation

What is driving higher local consumer prices?

Last month, Statistics SA announced that annual inflation had accelerated to 4.4% in April, up from 3.2% in March, which is slightly higher than the anticipated 4.3%. The last time the consumer price index (CPI) reached similar highs was prior to the Covid-19 lockdown in February 2020 when it reached 4.6% before dropping to 3% in April 2020 and 2.1% in May 2020.

As expected, the South African Reserve Bank (SARB) elected to hold interest rates steady when they met in May given that the CPI figures remain below the mid-point of the inflation target (being 4.5%). Despite the slightly higher than expected inflation figure, the bond market barely blinked and the rand showed similarly little reaction.

When assessing inflation data figures, it is important to remember that they are retrospective, or backward-looking. Looking ahead at the inflation rates that lie in our future is arguably a more valuable exercise, particularly if actual inflation turns out to be meaningfully higher or lower than markets had anticipated and the extent to which markets have priced this in.

The difference between the yields on SA government-issued nominal bonds and their duration-matched nominal bond counterparts provides some indication of what the market is currently pricing in.

Our analysis indicates that over the medium term the market anticipates meaningful acceleration in inflation to between 5% and 5.5%, but for this to stabilise under 6%. Our analysis is limited by the liquidity of the SA inflation-linked bond market where price discovery might not be quite as revealing as it is in the nominal bond market and the lack of perfectly duration-matched instruments. Nevertheless, it still provides some useful initial data.

Significant rand weakness is one of the risks of the market's implied inflation view. The recent strength of the rand has, to some extent, prevented inflation from accelerating more than it already has. It is important to remember, however, that inflation is a year-on-year number. What this means is that if the rand stabilises at these levels – or even strengthens moderately over the next year – the protection afforded by it to SA inflation rates will fade over time.

Oil prices are another risk. These have already rallied significantly from Covid-19-induced lows and some market dislocation in 2020 when short-term oil futures contracts were maturing into an environment where counterparties were not able to take physical delivery. There may be room for oil prices to rally even further as developed markets complete their vaccination rollout plans and as their economies reopen more fully.

Commodity prices also pose a risk. While high iron ore prices are welcome developments for local mining companies and the windfall taxes that will accrue to National Treasury via Sars, if they take the form of higher maize prices – as they already have – this will be a negative for a moderation in inflation given that higher maize prices translate into higher food prices. Food inflation, which saw an uptick in the last quarter of 2020, is currently running at 10%.

How the SARB responds to an environment that is clearly angled towards higher inflation rates will be key in the coming months. The SARB's view – which is shared by central banks globally – is that accelerating inflation and the risk that it accelerates even further than expected, are transitory and therefore well-contained.

A similar analysis to the one conducted for breakeven inflation can be applied to interest rates to determine what the market anticipates for future interest rate movements. This analysis reveals that only one interest rate increase of 25 basis points is anticipated in the next three to six months, with another similar increase before the end of 2021.

Although interest rate increases are seldom good news, encouragingly they will still be significantly lower than they were at the start of the rate-cutting cycle, which will be good news for an economy battered by the pandemic-induced lockdowns and a persistently high unemployment rate. ■

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